EXECUTIVE SUMMARY

WHAT IS INTEGRATION AND WHY SHOULD IT BE BENEFICIAL?

Currently, our tax system taxes corporate profits distributed to shareholders at least twice—once at the shareholder level and once at the corporate level. If the distribution is made through multiple unrelated corporations, profits may be taxed more than twice. If, on the other hand, the corporation succeeds in distributing profits in the form of interest on bonds to a tax-exempt or foreign lender, no U.S. tax at all is paid.

The two-tier tax system (i.e., imposing tax on distributed profits in the hands of shareholders after taxation at the corporate level) is often referred to as a classical tax system. Over the past two decades, most of our trading partners have modified their corporate tax systems to "integrate" the corporate and shareholder taxes to mitigate the impact of imposing two levels of tax on distributed corporate profits. Most typically, this has been accomplished by providing the shareholder with a full or partial credit for taxes paid at the corporate level.

Integration would reduce three distortions inherent in the classical system:

(a) <u>The incentive to invest in noncorporate rather than corporate businesses</u>. Current law's double tax on corporations creates a higher effective tax rate on corporate equity than on non-corporate equity. The additional tax burden encourages "self-help" integration through disincorporation.

(b) <u>The incentive to finance corporate investments with debt rather than new equity</u>. Particularly in the 1980s, corporations issued substantial amounts of debt. By 1990, net interest expense reached a postwar high of 19 percent of corporate cash flow.

(c) <u>The incentive to retain earnings or to structure distributions of corporate profits in a manner to avoid the double tax</u>. Between 1970 and 1990, corporations' repurchases of their own shares grew from \$1.2 billion (or 5.4 percent of dividends) to \$47.9 billion (or 34 percent of dividends). By 1990, over one-quarter of corporate interest payments were attributable to the substitution of debt for equity through share repurchases.

These distortions raise the cost of capital for corporate investments; integration could be expected to reduce it. To the extent that an integrated system reduces incentives for highly-leveraged corporate capital structures, it would provide important non-tax benefits by encouraging the adoption of capital structures less vulnerable to instability in times of economic downturn. The Report contains estimates of substantial potential economic gains from integration. Depending on its form, the Report estimates that integration could increase the capital stock in the corporate sector by \$125 billion to \$500 billion, could decrease the debt-asset ratio in the corporate sector by 1 to 7 percentage points and could produce an annual gain to the U.S. economy as a whole from $2.5 billion to $25 billion.

PROTOTYPES

This Report defines four integration prototypes and provides specifications for how each would work. Three prototypes are described in Part II: (1) the dividend exclusion prototype, (2) the shareholder allocation prototype, and (3) the Comprehensive Business Income Tax (CBIT) prototype. In addition, in Part IV, titled "Roads Not Taken," the Report describes the imputation credit prototype and a dividend deduction alternative. For administrative reasons that the Report details, we have not recommended the shareholder allocation prototype (a system in which all corporate income is allocated to shareholders and taxed in a manner similar to partnership income under current law). Simplification concerns led us to prefer the dividend exclusion to any form of the imputation credit prototype.

In the dividend exclusion prototype, shareholders exclude dividends from income because they have already been taxed at the corporate level. Dividend exclusion provides significant integration benefits and requires little structural change in the Internal Revenue Code. When fully phased in, dividend exclusion would cost approximately $13.1 billion per year.

CBIT is, as its name implies, a much more comprehensive and larger scale prototype and will require significant statutory revision. CBIT represents a long-term, comprehensive option for equalizing the tax treatment of debt and equity. It is not expected that implementation of CBIT would begin in the short term, and full implementation would likely be phased in over a period of about 10 years. In CBIT, shareholders and bondholders exclude dividends and interest received from corporations from income, but neither type of payment is deductible by the corporation. Because debt and equity receive identical treatment in CBIT, CBIT better achieves tax neutrality goals than does the dividend exclusion prototype. CBIT is self-financing and would permit lowering the corporate rate to the maximum individual rate of 31 percent on a revenue neutral basis, even if capital gains on corporate stock were fully exempt from tax to shareholders.

POLICY RECOMMENDATIONS

In addition to describing prototypes, the Report makes several basic policy recommendations which we believe should apply to any integration proposal ultimately adopted:

(a) <u>Integration should not result in the extension of corporate tax preferences to shareholders</u>. This stricture is grounded in both policy and revenue concerns and has been adopted by every country with an integrated system. The mechanism for preventing passthrough of preferences varies; some countries utilize a compensatory tax mechanism and others simply tax preference-sheltered income when distributed (as we recommend in the dividend exclusion prototype). Both of these mechanisms are discussed in the Report.

(b) Integration should not reduce the total tax collected on corporate income allocable to tax-exempt investors. Absent this restriction, business profits paid to tax-exempt entities could escape all taxation in an integrated system. This revenue loss would prove difficult to finance and would exacerbate distortions between taxable and tax-exempt investors.

(c) Integration should be extended to foreign shareholders only through treaty negotiations, not by statute. This is required to assure that U.S. shareholders receive reciprocal concessions from foreign tax jurisdictions.

(d) Foreign taxes paid by U.S. corporations should not be treated, by statute, identically to taxes paid to the U.S. Government. Absent this limitation, integration could eliminate all U.S. taxes on foreign source profits in many cases.

A table summarizing the characteristics of each of the prototypes follows.

OBJECTIVES OF THE REPORT

This Report is not a legislative proposal but rather a source document to begin the debate on the desirability of integration. This Report concludes that integration is desirable and presents a variety of integration mechanisms. A major reform such as integration should be undertaken only after appropriate deliberation and consideration of public comments. In light of the increasing isolation of the United States as one of the few remaining countries with a classical tax system, serious consideration of integration is now appropriate.

Comparison of the four principal integration prototypes

Issues	Dividend Exclusion Prototype	Shareholder Allocation Prototype	CBIT Prototype	Imputation Credit Prototype
	Prototype			
Rates				
a) Distributed Income	Corporate rate	Shareholder rate[1]	CBIT rate (31 percent)	Shareholder rate[1]
b) Retained Income[2]	Corporate rate (additional shareholder level tax depends on the treatment of capital gains; see Chapter 8)	Shareholder rate	CBIT rate (additional investor level tax depends on the treatment of capital gains; see Chapter 8)	Corporate rate (additional shareholder level tax depends on the treatment of capital gains; see Chapter 8)
Treatment of non-corporate businesses	Unaffected	Unaffected	CBIT applies to non-corporate businesses as well as corporations, except for very small businesses.	Unaffected
Corporate tax preferences	Does not extend preferences to shareholders. Preference income is subject to shareholder tax when distributed.	Extends preferences to shareholders.	Does not extend preferences to investors. Preference income is subject to compensatory tax or investor level tax when distributed.	Does not extend preferences to shareholders. Preference income is subject to shareholder tax when distributed.
Tax-exempt investors	Corporate equity income continues to bear one level of tax.	Corporate equity income continues to bear one level of tax.	A CBIT entity's equity income and income used to pay interest bear one level of tax.	Corporate equity income continues to bear one level of tax.
Foreign source income	Foreign taxes are creditable at the corporate level, but shielded income is subject to shareholder tax when distributed.	Foreign taxes are creditable at the corporate level and at the shareholder level.	Foreign taxes are creditable at the entity level, but shielded income is subject to compensatory tax or an investor level tax when distributed.	Foreign taxes are creditable at the corporate level, but shielded income is subject to shareholder tax when distributed.
Foreign investors	Corporate equity income continues to bear tax at the corporate level and current withholding taxes (eligible for treaty reduction) continue to apply to distributions.	Corporate equity income continues to bear tax at the corporate level and current withholding taxes (eligible for treaty reduction) continue to apply to distributions.	A CBIT entity's equity income and income used to pay interest bear tax only at the entity level, and no withholding taxes are imposed on distributions to equity holders or on payments of interest.	Corporate equity income continues to bear tax at the corporate level and current withholding taxes (eligible for treaty reduction) continue to apply to distributions.
Treatment of debt	Unaffected	Unaffected	Equalizes treatment of debt and equity	Unaffected (unless bondholder credit system adopted)

[1]Plus 3 percentage points of corporate level tax not creditable because the prototype retains the 34 percent corporate rate but provides credits at the 31 percent shareholder rate.

[2]Assuming no DRIP. See Chapter 9.